NC Justice Center
Opportunity and Prosperity for All

BTC Brief

NC BUDGET & TAX CENTER

August 27 2009

# WISHFUL THINKING: Claims that state tax increases cause job loss are unfounded

*Timely, accessible, and credible analysis of state and local budget and tax issues*

## Key Findings:

**1 – North Carolina's recently enacted state tax increases are small relative to the size of the state economy. Moreover, the fact that other states are also enacting tax increases should leave North Carolina's tax levels unchanged relative to its peers.**

**2 – Claims that state tax increases cause job loss are based on flawed methodology; examination of credible research suggests the tax increases will not hurt employment.**

## Overview

The fiscal year 2009-2011 (FY 09-11) General Fund budget includes a tax increase package that when fully implemented will generate an additional $1.3 billion in revenue. The tax package consists primarily of a one-cent increase in the state sales tax, an income tax surcharge on household income above $100,000, and small increases in taxes on alcohol and tobacco products. 23% of the 2010 budget and 31% of the 2011 budget gap are supported by funding from the tax increase. Without this additional tax revenue many of the more drastic spending reductions considered this year would have been enacted, such as increasing class sizes in early grades and freezing enrollment in the state's children's health insurance program. Those cuts certainly would have caused job losses in both the private and public sectors, while credible research concludes the revenue increases likely will not negatively impact the job market.

## Get the Facts: Putting the tax increase into context

FIGURE 1

| 2009 TAX PACKAGE RELATIVE TO SIZE OF NC ECONOMY | |
|---|---|
| Annual Revenue Impact of Final Tax Package | $1,300,900,000 |
| NC Total Personal Income (2008) | $317,612,906,000 |
| Tax package as % of TPI | 0.41% |
| NC Gross Domestic Product (2008) | $400,192,000,000 |
| Tax package as % of NC GSP | 0.33% |

When fully implemented the tax increase package included in the final budget will generate $1.3 billion per year. Though not insignificant, this amount is not likely to alter North Carolina's overall tax levels compared to the previous year's or compared to other states. According to the most recent census data on state and local finances North Carolina's state and local governments collected $30.013 billion in tax revenue in FY 2006, which is equivalent to thirty times the amount of the recently enacted state tax increases.

P.O. Box 28068
Raleigh, NC
27611-8068
Editor: Elaine Mejia
919/856-2176
elaine@ncjustice.org
www.ncjustice.org

Relative to the size of the overall state economy, the tax increase package is modest. NC Gross State Product (GSP), a rough measure of the size of the state's economy, was $400.1 billion in 2008 **(Figure 1).** Another way to measure the state's economy and residents' ability to pay for government services is the size of North Carolina's total personal income (TPI) which was $317.6 billion in 2008. The new tax package is only 0.33% of GSP and 0.41% of TPI.

Relative to the size of the overall state economy, the tax increase package is modest. NC Gross State Product (GSP), a rough measure of the size of the state's economy, was $400.1 billion in 2008 (Figure 1). Another way to measure the state's economy and residents' ability to pay for government services is the size of North Carolina's total personal income (TPI) which was $317.6 billion in 2008. The new tax package is only 0.33% of GSP and 0.41% of TPI.

Most other states facing fiscal crises also raised taxes in either 2008 or 2009. According to the Center on Budget and Policy Priorities, since the recession began, more than 30 states have enacted tax increases in response to their budget shortfalls.[1] Tennessee, Mississippi, Virginia, Florida, Kentucky and Maryland are among the states that increased taxes in the past year.

## Flawed methodology used to predict job losses from tax increases

Critics of North Carolina's recent move to raise state taxes in response to the fiscal crisis caused by the recession have argued that the tax increase will reduce private-sector employment. In fact, one organization opposed to the tax increase went so far as to conclude that a proposal included in the House budget—but not in the final budget— to add two top income tax brackets would reduce private-sector employment by more than 2,817 positions.[2] The methodology used to predict such job losses, produced by the Beacon Hill Institute, is highly flawed. Researchers at the University of Arizona analyzed the Institute's methodology used to produce these estimates and concluded, among other things, that the "model is not useful for forecasting," "its use is very limited for impact analysis" and that it "does not consider the expenditure side of government services."[3]

The well established economic view is that during a recession and in the short-run, raising taxes to help close state budget deficits is an efficient and timely method for maintaining employment and promoting economic growth. A key reason is that state expenditure of revenue is concentrated in-state, whereas households may decide not to spend those tax dollars as freely as they would in a better economic climate or choose to spend on goods and services out-of-state.[4]

## Tax increases to pay for increased education spending benefit the economy

The view that enhancing revenues in a recession causes job loss does not adequately take into account the jobs that would be lost from cutting state spending, the alternative to tax increases. For instance, NC DPI estimated in May that over 6000 teaching jobs and 4000 teaching assistant jobs would be lost, jobs in every town and city in every county, if the initial House May budget proposal to meet the deficit exclusively through cuts was enacted.[5] This would have further slowed a struggling economy.

Models that attempt to analyze the net effects of tax increases and the coordinate government spending conclude that tax increases do not result in decreased private-sector employment. Economists with the National Education Association, for example, recently modeled the employment impacts of a hypothetical 2% increase in consumption taxes in all 50 states, with the resulting revenue going to education, and found there would actually be a positive net effect on employment from such a move. The study predicted that if North Carolina took such action, the state's employment numbers would actually increase by 4,800 in the first year and by 6,400 in the tenth year.[6]

## NC experience after 2001 tax increase provides evidence of economic impacts

In 2001, North Carolina's state leaders enacted a tax increase package similar to the tax package that passed recently. The 2001 package increased the state sales tax rate by half a cent and added a top income tax bracket on households earning more than $100,000. A look at North Carolina's experience following the 2001 tax increase, the majority of which has since expired, provides evidence to counter claims that state tax increases negatively impact the economy.

Since the 2001 tax increase, North Carolina's population has increased rapidly—an astounding 17% since 2000. The NC Budget & Tax Center looked at Internal Revenue Service and census data and found that the incomes of those who moved to the Tar Heel state in recent years were higher than the incomes of those who moved out of the state. During the period from 2001-02 to 2006-07, a period during which the 2001 tax increases were in place, the average income of the households that moved to North Carolina was $1,512 higher than the incomes of those who moved away. During the same period, North Carolina gained $11 billion in taxable income and 204,000 households, on net, as a result of moves between states. Moreover, during this period North Carolina ranked third in the nation in households gained versus households lost and third in net taxable income gained as a result of moves between states.[7]

## Conclusion

Unlike the federal government, state governments are constitutionally prohibited from operating under deficits in order to avoid spending cuts and tax increases when tax revenues decline. Without the option of deficit spending, most states, including North Carolina, choose to take a balanced approach by cutting spending and raising revenue. The additional revenue raised will be distributed into local economies via payments to pay government workers and contractors (such as doctors who see Medicaid clients). It is important that North Carolina's overall tax levels not deviate significantly from other states or as a share of the state's ability to pay, but there is no evidence that the state's recently enacted tax increase will put North Carolina in such a position. Taking a balanced approach to addressing the budget shortfall allowed the state to avoid major setbacks in public programs and avoid laying of tens of thousands of state workers, which would have had negative effects on the state economy.

1. See Johnson, N., Nicholas & Pennington (2009), "Tax Measures Help Balance State Budgets: A Common and Reasonable Response to Shortfalls," http://www.cbpp.org/cms/index.cfm?fa=view&id=2815

2. Americans for Prosperity of NC (2009) "Help Stop the Income Tax Hike," Action alert in response to House of Representatives income tax proposals. Job loss claims produced by the Beacon Hill Institute's STAMP methodology.

3. Charney & Marshall (2003) "Modeling Practices and Their Ability to Assess Tax/Expenditure Economic Impacts," Economic and Business Research Department, Eller College of Business and Public Administration, The University of Arizona - Tucson. October 2003.

4. For a more detailed enunciation of the argument see, Orszag & Stiglitz (2008) "Budget Cuts Vs. Tax Increases at the State Level: Is One More Counter-Productive Than The Other During a Recession?" Center on Budget and Policy Priorities (http://www.cbpp.org/cms/index.cfm?fa=view&id=1346) . Also see McNichol, Nicholas & Shure (2009) "Raising State Income Taxes on High-Income Taxpayers," Center on Budget and Policy Priorities (http://www.cbpp.org/cms/index.cfm?fa=view&id=2792)

5. See "Statement From State Board Of Education Chairman and CEO Bill Harrison and State Superintendent June Atkinson on Potential Budget Cuts to Education," May 21, 2009. (http://www.dpi.state.nc.us/newsroom/news/2008-09/20090521-01)

6. National Education Association (2004) "School funding, Taxes, and Economic Growth: An Analysis of the 50 States," Research Working Paper, April.

7. Analysis of IRS state-to-state migration flows compiled by US Census Bureau for tax years 1995-2006.

Contact Steve Jackson: (919) 856-2151 or steve@ncjustice.org